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17 September 1974

MEMORANDUM FOR: Mr. Geza Feketekuty
Office of the Special Representative for Trade Negotiations
Old Executive Office Building

SUBJECT : Developed Countries: Recent Trends in Inflation

1. In response to our recent telephone conversation, we are forwarding the attached draft memorandum on inflation in developed countries for your and Mr. Eberle's use.

2. The study outlines the three fairly distinct phases of inflation from 1972 to the present -- from the initial demand-pull causes, through the oil and other commodity market disruptions, to the wage-push pressures now prevailing. Although expected to continue slowing, inflation will remain a serious problem in most developed countries well into 1975.

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Office of Economic Research

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DEVELOPED COUNTRIES: RECENT TRENDS IN INFLATION

Introduction

1. Inflation currently is viewed as the chief economic problem in almost all developed countries. Price increases began accelerating in mid-1972, gained momentum throughout 1973, and were proceeding at an unprecedented rate by early 1974. By mid-1974, wholesale prices in major OECD countries were on the average 36% above mid-1972 levels, making the price spiral the steepest and most sustained in post-war history. Consumer prices were up 22% on the average. Although the worst of the price rise is probably over, inflation will remain a serious problem in all developed countries through mid-1975 at least.

2. The price spiral has gone through several fairly distinct phases. The initial phase began in 1972, when many governments adopted expansionary monetary policies to spur growth. In that year, the money supply in most major countries increased at least 50% faster than nominal GNP. By mid-1973, commodity prices had risen to record levels and were a prime factor in the continuing inflation. Oil supply disruptions and the huge increase in oil prices last winter added impetus to this second round of inflation.

Anatomy of Inflation*

3. From the standpoint of individual countries, price increases in 1972-73 were the result mainly of rising costs for foodstuffs, industrial raw materials other than oil, and imported manufactures. Our analysis indicates that through 1973:

- higher costs for foodstuffs, raw materials, and imported manufactures accounted directly and indirectly for more than half of the wholesale price increase in most major countries;

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*To measure the impact of higher input prices on overall prices, we have used input-output tables for the major countries. The influence of higher costs for foodstuffs, raw materials, oil, imports of manufactured goods, and labor was measured by increasing the relevant rows in inverted input-output tables by the amount of the cost increase. In following this procedure, we were assuming that changes in costs are passed through, dollar for dollar.

- higher labor costs accounted for 10% to 15% of the wholesale price rise in most countries; and

- higher profits contributed appreciably to inflation in almost all major countries because shortages of many products and a general condition of excess demand allowed firms to widen profit margins.

4. Since the start of 1974 the primary causes of inflation have shifted markedly.

- Higher oil costs accounted, directly and indirectly, for roughly half the increase in wholesale prices in the first half of the year.

- Higher labor costs accounted for one-third or more of the price rise in most countries.

- Costs of commodities other than oil played an important, though declining, role.

- Profit margins generally declined, reflecting the contractionary impact on aggregate demand of the oil price hike and of anti-inflation measures in certain countries.

Inflation from Mid-1972 to Mid-1974

5. The doubling in commodity prices (see Figure I-1) between mid-1972 and mid-1974 was a global development resulting partly from national decisions to stimulate demand and partly from fortuitous factors that hurt supply. Adoption in early 1972 of expansionary policies -- particularly in the monetary field -- brought a coincident economic upturn in major countries. The resulting pressure on prices was intensified by poor crops in some countries and by last winter's oil supply disruptions and enormous subsequent rise in oil prices. Under these circumstances, efforts by individual governments to control the price spiral could scarcely be effective.

Causes of Increased Commodity Prices

6. Several factors contributed to the rise in commodity prices. One of the most important was crop shortfalls in

several countries. In the crop year ending in June 1973, world grain production fell 3%, compared with an average annual increase of 3.5% in 1960-71. Global demand for food, on the other hand, increased more than the usual 4%, largely because of rising demand in Communist countries and the LDCs. Grain output fully recovered last year, but supplies remained tight because global demand continued to increase substantially faster than the 3.0% long-term rate.

7. Unusually strong demand generated substantial price increases for numerous industrial raw materials. Demand rose especially fast last year, when industrial output in the major countries increased 12% -- double the long-term average. Capacity constraints prevented a corresponding increase in output of most raw materials. Copper production, for example, rose only 4% last year, compared with the 8% growth in consumption (see Table I-1). The resulting inventory drawdowns left commodity markets tight even before the oil crisis hit. Commodity prices then surged further, primarily because of heavy speculative buying to hedge against shortages, continuing price increases, and currency changes. Not until mid-1974, when speculation eased, did raw material prices generally return to pre-crisis levels.

8. The huge increase in oil prices gave inflation another hard push (see Table I-2). As a result of the OPEC countries' price hikes in October 1973 and January 1974, the delivered cost of crude oil for most importing countries has at least tripled. Countries with substantial crude oil production -- the United States and Canada -- have been affected much less than those with little or no output. For example, average crude oil prices in the United States are now 90% above a year ago, while Japan's are up 240%, in terms of yen.

Some Domestic Factors

9. Lack of surplus production capacity in key industries contributed to the price spiral in all major countries. Growth of capacity was slow in the early 1970s owing to the sluggish growth of investment. Investment in plant and equipment rose an average of only 3.8% annually in 1970-72, roughly half the long-term rate. In a few industries, notably steel and synthetic textiles, strong demand quickly produced a sellers' market that enabled firms to increase prices and profit margins.

10. Although investment generally recovered in 1973 (see Table I-3), growth in plant capacity apparently has

continued below normal. The lag is explained partly by the fact that time is needed to complete investment projects. Another reason, probably more important, is that a growing share of investment is going into equipment to control pollution, which yields little or no increase in production capacity. In the steel industry, for example, an estimated 10% to 15% of fixed investment now is devoted to pollution control. The Japanese have estimated that as much as 12% of total investment last year consisted of pollution-control equipment, possibly tripling the 1970 share.

Current Phase of Inflation

11. Current price pressures in the developed countries are essentially cost-push in nature. Basically the problem is that certain industries and labor are determined to restore their real income, which has been eroded by the redistribution of income to producers of oil and other key commodities. The response from labor has been to substantially increase wage demands. Enterprises are raising prices as circumstances demand or allow. Governments are avoiding wage controls, hoping instead to moderate inflation by constraining aggregate demand. With the slowdown in economic growth, national leaders apparently expect business to resist excessive wage settlements and to absorb a portion of higher labor costs by reducing profit margins.

Labor Costs

12. Wage rates are already increasing sharply (see Table I-4). Settlements negotiated in major West European countries during the first half of 1974 averaged around 20%, roughly 50% above last year. By and large, hourly wage rates during the first half of 1974 kept pace with inflation, but reduced working hours meant a cut in real income. More recent settlements call for pay rates to increase slightly faster than prices are now rising.

13. In contrast to 1973, wage increases this year are not being offset by productivity gains. With output stagnating or declining, the growth in output per man-hour has plummeted over the past six months. A major reason is that firms are reluctant to reduce their work forces in response to difficulties that they hope will be short-lived. As a result, unit labor costs are increasing substantially. In Japan, unit labor costs rose at a 19% annual rate in the first half of 1974, compared with only 3% in 1973 (see Table I-5). The increases in most other developed countries are smaller, but still large.

Other Factors

14. Capacity constraints are still putting pressure on prices in some industries. The problem is most evident in basic industries, which are operating near capacity and enjoying good profit margins. Steel prices, for example, have generally risen 30% since the start of 1974, while production costs on the average have risen 20% or less. Profit margins have narrowed for most other industries because weak demand kept prices from increasing as fast as production costs. The profit squeeze is particularly severe in the United Kingdom and Japan.

Prospects for Inflation Rates

15. Inflation will remain a serious problem in all developed countries through mid-1975, and probably beyond that time. We believe that consumer prices in major OECD countries will on the average increase at annual rates of 16% in the second half of 1974 and 14% in the first half of 1975. These rates compare with average annual increases of 3.5% in 1960-71. Wholesale prices are projected to rise by roughly 12% from mid-1974 to mid-1975 -- about five times the long-term annual average. The expected increases for consumer and wholesale prices are well below the rates experienced in the first half of 1974.

16. Japan, Italy, and the United Kingdom face the most severe continuing inflation. Higher labor costs alone will boost Japanese wholesale prices by an estimated 11% through mid-1975. Consumer prices will rise even faster, as previous cost increases are passed along to final consumers. Growing labor costs will be the chief cause of Italy's expected 20% rise in wholesale prices and Britain's expected 12% increase. West Germany's inflation rate probably will reach only about 8% because wage settlements have been more moderate than in other European countries.

17. Tight monetary and fiscal policies promise only limited success in curbing inflation. Constraints on aggregate demand can limit price increases only to the extent that business is induced to absorb cost increases. Profit margins in many industries have already been squeezed by the fall-off in demand in the first half of 1974. With costs continuing to rise, many firms will be inclined to reduce output rather than profits. Relaxation of demand-management policies would ease cost pressures by permitting higher production and more rapid productivity gains. If demand increased very much, however, production bottlenecks would surface fairly rapidly in certain industries.

18. Price increases are likely to erode a large part of recent wage hikes. Indeed, in Italy, real wages are expected to decline through mid-1975, and in the United Kingdom real wages will increase only by an estimated 3%. Accelerating wage demands could given considerable stimulus to inflation. In most developed countries, a 5% increase in unit labor costs would boost wholesale prices by about 2%.

19. Crop shortfalls this year threaten another round of exogenous price increases. Prices of most US farm commodities entering international trade have strengthened recently, following several months of decline from record highs. The London Economist index of prices for 16 internationally traded foodstuffs increased 3% in August alone. Low world stocks, withholding of commodities by farmers, and speculative buying prompted by adverse weather are contributing to the pressure on supplies and prices. Prices of industrial raw materials, on the other hand, are continuing a downward trend.

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Table I-1

Growth of World Consumption of Selected Industrial Materials

	Percent Increase	
	Average 1967-72	1973
Aluminium	8.1	13.1
Copper	5.4	8.0
Cotton	1.2	2.9
Nickel	1.7	11.6
Tin	0.6	6.7
Zinc	5.2	6.9

Table I-2

Impact of Oil Price Hikes

		Percent
	Increase in Delivered Price of Crude Oil Oct 1973 to Jun 1974[1]	Increase in Wholesale Prices
France	200	3.6
Italy	225	12.0
Japan	240	8.5
United Kingdom	165	5.0
United States	90	4.6
West Germany	165	5.9

1. In terms of national currency.

Table I-3

Developed Countries: Growth in Gross Fixed Investment[1]

			Percent Increase
	Average 1960-70	Average 1970-72	1973
France	9.0	6.7	6.6
Germany	7.3	2.3	1.8
Italy	4.9	0.6	12.0
Japan	15.4	4.5	19.3
United Kingdom	5.0	-3.2	12.0
United States	5.1	4.1	12.8

1. At constant prices, excluding residential construction.

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Table I-4

Developed Countries: Increase in Hourly Wage Rates

Percent

	First Half 1972	Second Half 1972	First Half 1973	Second Half 1973	First Half 1974
Canada	5.6	9.9	4.7	9.3	12.3
France	11.1	11.8	14.4	15.4	20.0
Italy	9.7	13.1	24.7	28.9	22.0
Japan	12.5	12.8	21.4	28.4	22.0
United Kingdom	12.3	19.3	6.4	16.8	25.4
West Germany	10.4	6.2	12.4	8.2	16.0

Table I-5

Developed Countries: Increase in Unit Labor Costs

Percent

	First Half 1972	Second Half 1972	First Half 1973	Second Half 1973	First Half 1974
Canada	2.8	5.7	1.1	9.6	4.9
France	3.9	5.2	6.1	11.9	16.0
Italy	5.8	0.3	12.2	21.5	17.0
Japan	2.5	2.15	0.4	7.8	19.0
United Kingdom	8.0	10.0	-0.3	14.5	16.0
West Germany	1.1	3.9	2.7	8.0	8.2